Inside Stage 3: How Expected Credit Losses Are Calculated After Default

When a borrower defaults, financial institutions move from predicting possible credit losses to estimating actual ones. Under IFRS 9, this transition marks entry into **Stage 3**—the credit-impaired category. At this point, the asset is no longer performing, and the focus shifts to estimating the *lifetime expected loss* after considering what can realistically be recovered through collateral, guarantees, or restructuring.

The process begins with **identifying default events**. These are not limited to 90-day past-due situations but extend to signs of unlikeliness to pay—such as distressed restructurings, bankruptcy proceedings, or the sale of a loan at a material economic loss. Once such indicators appear, the exposure is classified as Stage 3, and accounting rules require recognition of lifetime expected credit losses.

The next step is to determine the **Exposure at Default (EAD)**—the total amount that could be lost if no recovery occurs. This includes principal, accrued profit or interest, and any undrawn commitments likely to be used before or at default. For revolving facilities, a credit-conversion factor is applied to estimate how much of the undrawn balance could turn into exposure.

Once the exposure is established, risk teams estimate **Loss Given Default (LGD)**—the portion expected to remain unrecovered after taking into account collateral, guarantees, and other credit enhancements. Collateral values are adjusted using prudential haircuts and forward-looking macroeconomic assumptions to reflect potential market deterioration. For instance, a property pledged against a loan may be discounted further if economic indicators suggest falling real-estate prices.

With both EAD and LGD in place, the **Expected Credit Loss (ECL)** is calculated as the present value of future cash shortfalls. Since default has already occurred, the probability of default (PD) is assumed to be 100 percent, and the focus is on timing and amount of recoveries. Expected recoveries are projected across the workout period, discounted using the effective interest rate of the original instrument. If multiple outcomes are possible—such as successful restructuring, partial recovery, or liquidation—each scenario is weighted by its probability to ensure an unbiased estimate.

Governance plays a vital role throughout the process. Credit, risk, and finance functions jointly review each exposure to validate staging, assumptions, and collateral treatment. Independent validation or internal audit teams test the model's parameters and back-test historical recovery performance to ensure realism. Any manual overrides or judgmental adjustments are documented and approved at a senior committee level before provisions are finalized.

Finally, Stage 3 assets are **monitored continuously**. Actual recoveries, restructuring progress, and legal proceedings feed back into updated LGD and EAD estimates. When consistent performance resumes—typically after several timely repayments and the removal of default indicators—the exposure may be upgraded to Stage 2, subject to a defined cooling-off period. If, however, there is no reasonable expectation of further recovery, the asset may ultimately be written off, and any later recoveries recognized as income.

Step-by-Step Summary of the Stage 3 Provisioning Process

Step	Process Stage	Objective	Key Activities / Outputs
1	**Default Identification**	Recognize credit impairment	Identify 90 + DPD, unlikeliness-to-pay indicators, or distressed restructures
2	**Data Collection**	Compile full exposure data	Capture principal, accrued charges, undrawn commitments, collateral, guarantees
3	**EAD Estimation**	Measure exposure at default	Apply credit-conversion factors for undrawn lines; estimate prepayment or rollover behavior
4	**LGD Estimation**	Assess severity of potential loss	Adjust collateral for haircuts, market forecasts, and enforceability; compute recovery values
5	**ECL Computation**	Calculate lifetime expected loss	Apply PD = 100 %, multiply by LGD × EAD, discount future cash shortfalls using effective rate
6	**Scenario Weighting**	Reflect uncertainty and macro outlook	Weight alternative outcomes (e.g., restructuring, liquidation) by probability
7	**Governance & Validation**	Ensure prudence and accuracy	Review assumptions, approve overrides, back-test model performance
8	**Monitoring & Re-measurement**	Keep provision current	Update EAD and LGD as recoveries occur; reassess stage movement or write-off need

The Stage 3 process under IFRS 9 combines financial modeling, expert judgment, and ongoing governance. It ensures that provisions reflect not only the *occurrence of default* but also the *economic reality of loss*, aligning financial statements with the true recoverable value of credit-impaired assets.